PROFITABILITY AND BUSINESS DEVELOPMENT OF FOREIGN BANKS IN HONG KONG : THE CASE OF EUROPEAN BANKS IN DEVELOPING TRADE FINANCE BUSINESS

by

POON KAI LEUNG, JAMES

潘啟良

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(MR. DENIS WANG)

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ABSTRACT

Over the past decade, Hongkong people, and particularly the territory's business, pride themselves upon their resilience: the Beijing incident, Saddem Hussein's invasion of Kuwait, debate on the continuation of China's Most Favoured Nation (MFN) trade status with the United States, the controversy over the construction of Chek Lap Kok Airport, and so on. Despite all these hurdles that looked suspiciously, the people of Hongkong, who are entrepreneurial in spirit, ready to work and determined to succeed, can always manage to turn the corner.

As the saying goes "Hong Kong is China's gate and China is Hongkong's future", China is an important and expanding market that is growing hand in hand with Hong Kong's diversified financial facilities. Whilst the US economy is still showing no signs of emerging successful from recession and Japan is facing a slowing economy, many Europeans now present in Asia have focused attention on the region as trade between their home base and Asia continues to prosper. Most European banks are also establishing their footholds in Hongkong as China is contemplated as a priority for them. Thanks to the rapid expansion of import and export trade of

China and Hongkong, these European banks have taken bills financing as their core business. As a matter of fact, trade financing is their bread and butter, and the reason for their being in Asia is to leverage their relationships with the corporate customers back home. It is, therefore, the objectives to study the trade finance activities of these European banks in light of the growing importance of business for the bank's profitability and business development.

The main body of this research embraces three subjects: a profiling of organizational structure of the European banks in Hongkong; credit policy and procedures; and marketing and lending of trade finance. Through the indepth interviews with several selected European banks in Hongkong, information regarding the three areas are explored. Recommendations and proposals are then made on these areas in an attempt to sharpen the competitiveness of the banks in trade finance activities.

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PREFACE

I am particularly indebted to my research supervisor, Mr. Denis Y. L. Wang for his guidance and advice - without which this research would not have been completed.

During the course of this research, indepth interviews with experts from banks have greatly enhanced my understanding of this topic. Special thanks are addressed to Mr. Johnny Y. S. Cheng, Union Bank of Switzerland; Michael Grabowski, Bayerische Vereinsbank AG; Mr. Maxwell Yeung and Mr. Thomas P.K. Tao, Banque Worms; and Mr. Richard McDonald, Westdeutsche Landesbank.

Last, but no the least, acknowledgements are also gratefully extended to all persons who have assisted in my completion of this study.

Despite all the suggestions and assistance rendered to me, it is still possible that errors and omissions occur in this research report. This, certainly, is up to my own responsibility.

James K. L. Poon

Hong Kong

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CHAPTER 1

INTRODUCTION

Review of the Economic and Banking Environment

Over the past decade, Hong Kong has rapidly emerged as a leading international financial centre. There are now well over 400 foreign-owned banks, coming from some 50 countries (Table 1.1). Among them are 76 of the top 100 banks in the world in terms of total assets including the locally-based Hongkong and Shanghai banking Corporation (Table 1.2). Hong Kong ranks third in the world in terms of overseas bank representation. The assets and liabilities of the banking sector, as at the end of 1990, stood at around US$6,710 billion. (Table 1.3)

The financial sector's contribution to the economy has grown significantly in recent years. In 1987, it accounted for

18 percent of GDP, compared with a 22 percent share for manufacturing industry. By comparison, its contribution to GDP in the early 1970s was only half that of manufacturing industry.

There are several important factors that have contributed to the development of Hong Kong as an international financial centre.

One key factor is location. Hong Kong is the gateway to China and China is Hong Kong's future. Thanks to the sound establishment of financial services of the territories, Hong Kong is ideally located for trade and investment on the mainland.

Another factor is the favorable business climate. We have first class telecommunications and international transport networks; complete freedom in the movement of money and capital; a freely convertible currency; low and stable rates of corporate and personal taxation; a high quality and hardworking workforce - our only natural resource apart from the finest deep water port in the whole of South china; widespread use of English and a legal system based on the common law.

Thirdly, we have a buoyant and open economy free from trade barriers or restrictions. Overseas entity in good standing can freely establish company in the territory without any protection for local businesses.

Finally, the Hong Kong Government is strongly committed to a free market philosophy. The government perceives its role as providing the necessary environmental and legislative framework in which businesses can flourish.

It is undeniable that Hong Kong's success is a tribute to the hard work, ingenuity, entrepreneurial ability and adaptability of its people. But undoubtedly, whatever our past achievements, our future is connected inextricably to that of China.

Since China's adoption of its open door policy in 1978, we have seen rapid growth and development in the economic links between the territory and the mainland.

In 1985, China overtook the United States to become Hong Kong's largest trading partner, and now accounts for nearly a third of our total trade. Hong Kong in turn overtook Japan in 1987 to become China's largest trading partner.

Underscoring this growth in trade had been Hong Kong's rapid re-emergence as the principal entrepot for China trade -

about 33 percent of Hong Kong's re-exports are now destined for China. The products concerned include textiles, machinery, electrical appliances and raw materials mainly from Japan, Taiwan and the US. China is also our main supplier, exporting to US textiles, garments, foodstuffs and light consumer goods of which over 80 percent are re-exported. In all, over 80 percent of Hong Kong's total re-exports involve trade with China, either as a source or as an outlet.

China is now also our second largest market for domestic exports after the US. This growth in bilateral trade with China has contributed to our recent strong economic performance. It has also helped China to fulfil its policy of opening to the outside world. Outward processing plays a significant part in large trade flows between Hong Kong and China.

Indeed, nearly half of Hong Kong's total exports to China are in connection with outward processing. It has been estimated that, in Guangdong Province alone, there are now around two million people employed directly or indirectly by Hong Kong businesses. This more than doubles the total number employed in the manufacturing sector in Hong Kong.

Hong Kong's efficiency as an entrepot and trans-shipment centre has allowed China to expand its trade and thereby increase its foreign exchange earnings. Furthermore, Hong Kong is the most important source of direct foreign investment in China, accounting for about 70 percent of all external investment. Investment is varied and includes projects, mainly in Guangdong Province, in hotel construction and the textile, clothing and electronics industries, the construction of a nuclear power station, whose output will mainly be taken by Hong Kong, and a "SuperHighway" improving road communications with territory.

China's investments in Hong Kong are now substantial, too. Companies with mainland interests have made substantial investments in the territory in areas such as airlines, hotels and major infrastructural projects. China has made increasing use of Hong Kong's financial markets to raise capital. A number of syndicated loans raised in Hong Kong have been used to finance key industrial projects in China, including the construction of steel mills, chemical plants and power stations.

These trends seem set to continue, notwithstanding recent events, with maintenance of China's open door policy. It is noteworthy that, in addition to almost all provinces and major cities, all the Special Economic Zones (SEZ) in China have established permanent representative offices in Hong Kong.

Over the past decade, Hong Kong has played an important role in helping China to carry out its modernization programme. Hong Kong is expected to continue to be, not only a source of trade and investment, but also an economic and financial centre linking China with the rest of the world. With the continuous prosperous economy and improving political environment, this will be to the mutual benefit of both Hong Kong and China.

Objectives and Scope of the Project

Because of Hong Kong's important position in trade and business with China, Hong Kong, as a leading trade and entrepot community, reaped the benefits of encouraging economic developments of the larger industrial nations, namely the US, Japan, West Germany, and other European countries. One common denominator that has propelled this growth is trade finance. Nearly all Hong Kong export business is done on letter of credit terms, which means the buyer's bank agrees to pay the seller's bank for the goods exported even if the buyer itself turns out to be unable to pay. That emphasis continues, more so now, in the wake of the explosive growth in the export-driven economies in the Asian Pacific region. Most foreign banks in Hong Kong have managed to build up businesses in bills financing. This covers imports and exports either for Hong Kong's own use, related to its consumption, or for transformation.

In fact, Hong Kong as an entrepot or reinvoicing centre has also given bank further opportunities. As a major port servicing the Asian Pacific region and China, Hong Kong will continue to serve as a springboard to trade finance activities.

In general, most European banks have not really got themselves involved in the HK$ market. Because of this, many have to rely on the foreign exchange swaps for their funds, and some of them borrow from others which have bigger deposit bases. As a result, most of these banks have tended to concentrate, one way or another, on investment banking, corporate lending, trade financing (which is the emphasis), and private banking. These areas are all highly competitive and the markets, over-crowded. Some banks have, therefore, taken the initiative to sharpen their competitiveness in the trade finance area. The provision of trade finance services to large corporate customers back home are gaining popularity, in line with the expansion of trade between Asian-Pacific region and the emerging unified Europe. This is also the reason why I have my focus of study on the European banks in Hong Kong.

In light of the importance of trade financing, the overall trade financing activities will be studied in the first part of this paper through the following perspectives :

a. Organizational structure

b. Bills Operation

c. Credit and Loan Administration

d. Marketing Function.

Based on the findings secured from all the interviews, the paper proposes a modified organizational structure which can be adopted by some foreign banks to run smoothly their operations and hence sharpen their competitiveness in trade financing. Besides, the paper proposes a framework for credit policy and assessment and marketing process which can serve as a useful reference for the practising credit analysts and account managers in trade financing field.

Research Methodology

In this project, two major research methodologies are employed in order to explore in depth the trade finance activities of the European banks.

a. Library Research

An extensive library research is conducted to gather both qualitative and quantitative information. First of all, general knowledge of trade financing instruments and techniques is studied through literature and periodicals. Grasping background information in this perspective will contribute to a thorough understanding of what the interviewing banks reveal concerning their trade finance activities. In addition, secondary information pertinent to the development of the banking sector from a macro point of view were also explored from various journals. Particular attention was paid to the significant changes in the economic environment of both Hong Kong and Mainland. Last but not the least, statistical information of import and export was secured from the Hong Kong Monthly Digest published by the Hong Kong Government. With a clear picture of the changes in trading pattern between Hong Kong and its major trading partners, we can better understand any strategic moves formulated and implemented by the foreign banks in the past decade and future.

b. Indepth Interviews

Primary information was obtained through indepth interviews with open questions. For reference purpose, the list of questions are prepared in Appendix I. In each interview, the chief managers of the selected European banks were chosen as the target interviewee. In particular, managers from Operations Department and Marketing Department were invited to express their viewpoints in trade financing.

c. Sampling

Table 1.4 is the list of licensed banks incorporated outside Hong Kong extracted from the "1990 Report from the Banking Commissioner". Among the 52 European licensed banks, the twenty banks incorporated in France, Germany and Switzerland are selected as the focus of study (Table 1.5). The targeted banks are easily identified from the "Asian Banker Handbook 91" which includes information such as address, name of chief manager in charge and contact telephone number. As the scope of the study has already been confined to banks from the three main countries, all twenty letters were sent to the target banks for interviews. The details of participants in the interview are listed in Appendix II for reference.

Limitations

Out of the twenty European banks that were invited to give an interviews, more than a quarter of them refused the requests due to the bank's policy. Even there were several banks which were more than willing to give interview, the managers concerned were reluctant to disclose important information such as figures in assets amount and business volume. Nevertheless, it is still fair to say that the interviewees could answer most of the questions, contributing greatly to the content of this project.

Naturally, limitations are numerous and future researchers are likely to encounter similar limitations unless the research environment is changed.

TABLE 1.1

NUMBER OF LOCAL BRANCHES OF AUTHORIZED INSTITUTIONS

Authorized institutions	Branches in Hong Kong		
	1988	1989	1990
Licensed banks			
- incorporated in H.K.	955	938	953
- incorporated outside H.K.	442	439	446
	1,397	1,377	1,399
Restricted license banks	11	10	11
Deposit-taking companies	72	65	63
	83	75	74

Source : Annual Report of the Commissioner of Banking for 1990

TABLE 1.2

PRESENCE OF WORLD'S LARGEST 500 BANKS IN HONG KONG

World Ranking[1]	Licensed overseas banks		
	1988	1989	1990
1 - 20	19	19	18
21 - 50	25	26	26
51 - 100	31	32	32
100 - 200	21	24	29
201 - 500	12	16	20

Source : Annual report of Commissioner of Banking for 1990

[1] Top 500 banks/banking groups in the world ranked by total assets less contra items. Figures are extracted from The Banker, July 1988, 1989 and 1990 issues.

TABLE 1.3

BALANCE SHEET : ALL AUTHORIZED INSTITUTIONS

	1988	1989	1990
Assets			
Cash & amount due from authorized institutions	462	528	556
Amount due from banks abroad	1,927	2,078	2,483
Loans and advances	962	1,272	1,789
Negotiable certificates of deposit	33	28	29
Bank acceptances and bank bills of exchange	19	24	21
FRN and commercial paper	90	93	94
Securities and investments	84	92	122
Other assets	119	132	140
Total assets	3,698	4,247	5,234
Liabilities			
Amount due to authorized institutions	461	522	551
Amount due to banks abroad	2,132	2,428	3,139
Deposits from customers	846	1,008	1,231
Negotiable certificates of deposit	34	34	36
Other liabilities	225	255	277
Total liabilities	3,698	4,247	5,234

Source : Annual Report of Commissioner of Banking for 1990

TABLE 1.4

AUTHORIZED INSTITUTIONS AND LOCAL REPRESENTATIVE OFFICES AS AT 31.12.1990

Licensed Banks

Incorporated In Hong Kong

Bank of Credit and Commerce Hong Kong Limited
Bank of East Asia, Limited (The)
Chekiang First Bank Ltd.
Chiyu Banking Corporation Limited
Commercial Bank of Hong Kong Limited (The)
Dah Sing Bank Limited
Dao Heng Bank Limited
First Pacific Bank Limited
Hang Seng Bank Ltd.
Hongkong & Shanghai Banking Corporation Ltd. (The)
Hongkong Chinese Bank Limited (The)
Hongkong Industrial and Commercial Bank Ltd.
Hua Chiao Commercial Bank Limited
International Bank of Asia Ltd.
Ka Wah Bank Limited
Kwong On Bank Limited
Liu Chong Hing Bank Limited
Nanyang Commercial Bank Limited
Overseas Trust Bank Ltd.
Po Sang Bank Ltd.
Security Pacific Asian Bank Limited
Shanghai Commercial Bank Ltd.
Tai Sang Bank Ltd.
Tai Yau Bank Ltd.
Union Bank of Hong Kong Ltd.
United Chinese Bank Ltd.
Wayfoong Finance Ltd.
Wing Hang Bank Ltd.
Wing Lung Bank Limited
Wing On Bank Ltd. (The)

Incorporated Outside Hong Kong

Algemene Bank Nederland N.V.
American Express Bank Limited
Amsterdam-Rotterdam Bank N.V.
Australia & New Zealand Banking Group Limited
Banca Commerciale Italiana
Banca Nazionale del Lavoro
Banca Nazionale dell'Agricoltura
Banco de Santander, S.A.
Banco di Napoli
Banco di Roma
Banco Exterior de Espana S.A.
Banco Hispano Americano
Bangkok Bank Limited
Bank Fur Gemeinwirtschaft AG
Bank Melli Iran
Bank Negara Indonesia 1946
Bank of America NT & SA
Bank of China
Bank of Communications
Bank of Fukuoka Ltd. (The)
Bank of India
Bank of Ireland
Bank of Montreal
Bank of New York (The)
Bank of New Zealand
Bank of Nova Scotia (The)
Bank of Scotland
Bank of Seoul
Bank of Tokyo Limited
Bank of Yokohama Ltd. (The)
Bankers Trust Company
Banque Indosuez
Banque Nationale de Paris
Banque Paribas
Banque Worms
Barclays Bank Plc
Bayerische Hypotheken-Und Wechsel-Bank AG
Bayerische Vereinsbank Aktiengesellschaft
Canadian Imperial Bank of Commerce
Cassa di Risparmio delle Provincie Lombarde
Chase Manhattan Bank N.A.
Chemical Bank
Chiba Bank, Ltd. (The)
China & South Sea Bank Limited (The)
China State Bank Limited (The)
Chung Khiaw Bank Limited
Chuo Trust & Banking Co. Ltd. (The)
Citibank N.A.
Commerzbank AG
Commonwealth Bank of Australia
Continental Bank, National Association
Credit Agricole
Credit Commercial de France
Credit Lyonnais
Credit Suisse
Creditanstalt-Bankverein
Credito Italiano
Dai-Ichi Kangyo Bank Limited

Licensed Banks (continued)

Daiwa Bank Limited
Den Danske Bank Aktieselskab
Den norske Bank AS
Deutsche Bank AG
Development Bank of Singapore Ltd. (The)
DG Bank - Deutsche Genossenschaftsbank
Dresdner Bank AG
Equitable Banking Corporation
First Interstate Bank of California
First National Bank of Boston
First National Bank of Chicago (The)
Fuji Bank Limited (The)
Generale Bank Overseas (Belgium) "Belgian Bank"
Hamburgische Landesbank Girozentrale
Hanil Bank
Hokkaido Takushoku Bank Limited (The)
Hokuriku Bank, Ltd. (The)
Indian Overseas Bank
Industrial Bank of Japan, Limited (The)
Juroku Bank, Ltd. (The)
Kincheng Banking Corporation
Korea Exchange Bank
Kredietbank N.V.
Kwangtung Provincial Bank (The)
Kyowa Bank Limited (The)
Lloyds Bank Plc
Long-Term Credit Bank of Japan Limited (The)
Malayan Banking Berhad
Manufacturers Hanover Trust Company
Mellon Bank NA
Midland Bank Plc
Mitsubishi Bank Ltd. (The)
Mitsubishi Trust and Banking Corp. (The)
Mitsui Taiyo Kobe Bank, Limited (The)
Mitsui Trust and Banking Co. Ltd. (The)
Morgan Guaranty Trust Company of New York
National Australia Bank Limited
National Bank of Canada
National Bank of Pakistan
National Commercial Bank Limited
National Westminster Bank Plc
Nippon Credit Bank Limited (The)
Nishi-Nippon Bank, Ltd. (The)
NMB Postbank Groep N.V.
Nordbanken
Norwest Bank Minnesota N.A.
Ogaki Kyoritsu Bank, Ltd. (The)
Osterreichische Landerbank, AG
Oversea-Chinese Banking Corporation Ltd.
Overseas Union Bank Ltd.
Philippine National Bank
Pittsburgh National Bank
Rabobank Nederland
Republic National Bank of New-York
Royal Bank of Canada
Royal Bank of Scotland Plc (The)
Saitama Bank Ltd. (The)
Sanwa Bank Ltd.
Security Pacific National Bank
Shizuoka Bank Ltd. (The)
Sin Hua Trust, Savings & Commercial Bank Ltd.
Skandinaviska Enskilda Banken
Societe Generale
Standard Chartered Bank
State Bank of India
State Bank of Victoria
Sumitomo Bank Ltd.
Sumitomo Trust & Banking Co. Ltd. (The)
Svenska Handelsbanken
Swiss Bank Corporation
Tokai Bank, Ltd. (The)
Toronto-Dominion Bank
Toyo Trust and Banking Co. Ltd. (The)
UCO Bank
Union Bank of Switzerland
United Overseas Bank Ltd.
Westdeutsche Landesbank Girozentrale
Westpac Banking Corporation
Yasuda Trust & Banking Co. Ltd. (The)
Yien Yieh Commercial Bank Ltd. (The)

Source : Annual Report of Commissioner of Banking for 1990

TABLE 1.5

AUTHORIZED INSTITUTIONS:COUNTRY/REGION OF BENEFICIAL OWNERSHIP

Country/Region	Licensed Banks 1988	1989	1990
Asia & Pacific			
Hong Kong	19	15	15
Australia	4	5	5
China	15	15	15
India	4	4	4
Indonesia	3	3	3
Japan	28	30	31
Malaysia	2	3	2
New Zealand	1	1	1
Pakistan	1	1	1
Philippines	2	2	2
Singapore	4	4	5
South Korea	3	3	3
Thailand	1	1	1
Others	-	-	-
Sub-total	87	87	88
Europe			
Austria	1	2	2
Belgium/Luxembourg	3	3	3
Denmark	-	-	1
France	8	8	8
Germany	8	9	9
Italy	6	7	7
Netherlands	3	3	4
Norway	1	1	1
Republic of Ireland	1	1	1
Spain	1	3	3
Sweden	3	3	3
Switzerland	3	3	3
United Kingdom	7	7	7
Others	-	-	-
Sub-total	45	50	52
Middle East	2	2	2
North America	26	26	26
Grand Total	160	165	168

Source : Annual Report of the Commissioner of Banking for 1990

CHAPTER II

THE BANKING SYSTEM: AN OVERVIEW

Banking Structure

The business of banking in Hong Kong is confined to three types of authorized institutions under three-tier banking system. On the highest tier are the branches which act as commercial banks that operate as full licensed banks (FLBs). They require paid-in capital of HK$150 million and allow the acceptance of savings, demand and time deposits. On the lowest tier are the deposit taking companies (DTCs) which require paid-in capital of HK$25 million and can accept only time deposits of at least HK$100,000 with a minimum holding period of three months. Restricted licensed banks (RLB) constitute the middle tier requiring paid-in capital of HK$100 million and accepting time deposits of at least HK$500,000.

The representative offices do not officially engage in business activities. their role is merely to gather information for headquarters, distribute information, and maintain and expand business relations between foreign institutions and the Headquarters.

Function and Operation

Licensed banks in Hong Kong are usually described as "commercial banks" and have been accepted as such. In fact, most of them provide a wide spectrum of financial services ranging from consumer banking to corporate banking and trustee services through branches and specialized subsidiaries.

Most restricted licensed banks are wholesale banking arms of licensed banks engaging in merchant banking business, such as syndicated loans, underwriting services and corporate financial advice, to complement the retail operation of their holding banks. On the other hand, deposit-taking companies usually engage in retail business like hire purchase, mortgage loans and personal loans.

In line with a worldwide trend, restrictions on membership of depository institutions in the stock and futures markets in Hong Kong were lifted in 1985. Bank and DTC subsidiaries can now become full members of both stock and futures exchanges.

Interbank Ownership

Since the late 60s, many local banks have entered into partnership with or have come under the control of leading international banks. Due to the moratorium of new bank licenses imposed between 1965 and 1978, the only way for foreign banking institutions to enter the Hong Kong banking market then was to acquire control or ownership of local banks.

Representative Offices

After the bank runs in 1960, the Government imposed a moratorium on new bank licenses. Thereafter, foreign banks could only set up Representative Offices in the territory until the moratorium was lifted in 1978. Activities of such offices are restricted to liaison with and provision of financial advisory services to customers. They also help their head offices to solicit business opportunities in Hong Kong and China. However, many of them have also set up subsidiary DTC to participate in the local banking market and to provide merchant banking services to multinational corporations and developing countries in the Asia/Pacific Region.

Legislative Framework

The first set of banking laws of Hong Kong was enacted in 1948. This rudimentary Ordinance was later repealed and replaced in 1964 to tighten up the supervision of bank operation. After the historic bank runs in 1965, important amendments were made in 1967.

Despite a moratorium on banking licenses after the runs, deposit taking companies (DTC) could still be established. Thus, a separate DTC Ordinance was enacted in 1976 to supervise the operation of these quasi-banks. A major revision was made to the two ordinances in 1981, the famous three-tier system was established. There were also additional minor amendments in the subsequent years.

Following the development of Hong Kong into an international financial centre in early 80s, the Government found it necessary to strengthen prudential supervision of depository institutions. This need was further enhanced by the failure of Hang Lung Bank in 1983 and Overseas Trust Bank in 1985. Therefore, a new Banking Ordinance was enacted in 1986 to replace the two original ordinances governing banks and DTC.

Commissioner of Banking

The Commissioner of Banking is appointed by the Governor to promote the general stability and effective working of the banking system. The Commissioner's duty includes promoting and encouraging the proper standards of conduct and sound and prudent business practices amongst authorized institutions. The commissioner may from time to time publish by notice in the Gazette, for the guidance of authorized institutions, guidelines indicating the manner in which he proposes to exercise his functions. He also has the power to inspect and examine books, and assume control of authorized institutions.

Banking Associations

a. The exchange Banks' Association

The Exchange Banks' Association (EBA) was an unincorporated body, the history of which might be traced back to 1897. Its membership had always been voluntary but was confined to the "authorized banks" before exchange control was officially lifted in 1973. Thereafter, all banks were welcome to join. The EBA was dissolved in 1981 and replaced by an statutory body known as the Hong Kong Association of Banks (HKAB).

The EBA had four main functions. First, it provided a focal point for the Government's contacts and discussions with the banking industry as a whole. Second, it was the trade association for the industry and was closely involved with the technical and other matters of common interest. Third, it laid down rules to be followed by members, such as bank charges. Fourth, it was responsible for administering an Interest Rate Agreement which limits the maximum rates of interest payable by licensed banks to deposits taken from the public. These are more or less the functions of the Hong Kong Association of Banks.

b. The Hong Kong Association of Banks

In 1980 the Government decided to re-organize the EBA to enable views of all licensed banks to be heard in the formulation of policies of the association and to formalize the involvement of the Government in the formulation process. Hence, the Hong Kong Association of Banks was incorporated by Ordinance in 1981 to replace the EBA. Membership of this statutory body is compulsory for all licensed banks.

Interest Rate Rules

In order to prevent cutthroat competition for deposits, banks in Hong Kong have been abiding to an Interest Rate Agreement reached voluntarily in 1964. With the establishment of the HKAB, the Interest Rate Rules, as they are now called, have become statutory and any bank which do not abide to it will be penalized.

Under the prevailing rules, banks are divided into two categories. Category I consists of :

(1) the note-issuing banks;

(2) banks incorporated outside Hong Kong and China;

(3) banks incorporated in Hong Kong in which 25 percent of the issued capital are held directly or indirectly in aggregate by a bank in (1) or (2).

The rest are place under Category II.

The Interest Rate Rules are only applicable to Hong Kong dollar deposits payable on demand, at call, at short notice, or with an original term of maturity of 15 months or less. The only exception is deposits of HKD500,000 or above with an original term of maturity of less than 3 months.
No interest rate is payable to current (checking) account deposits. For other types of deposits covered by the rules, Category I banks quote the basic rates, and Category II banks may quote rates of not more than 0.5 percentage point above the basic rates.

From the above review, it is apparent to see that the banking sector highly adaptive to the macro-environment of the territory. The healthy development of the banking system not only contribute to the success of Hong Kong as one of the world's leading banking financial centre, but also provides numerous opportunities to foreign banks to compete in the market.

CHAPTER III

OVERVIEW OF INSTRUMENTS USED IN TRADE FINANCING

Letter of Credit

a. Definition of Documentary Letter of Credit

In simple terms, a documentary credit is a conditional bank undertaking of payment. Expressed more fully, it is a written undertaking by a bank (issuing bank) given to the seller (beneficiary) at the request, and in accordance with the instructions, of the buyer (applicant) to effect payment (that is, by making a payment, or by accepting or negotiating bills of exchanged) up to a stated sum of money, within a prescribed time limit and against stipulated documents. These stipulated documents are likely to include those required for commercial, insurance, or transport purposes, such as commercial invoice, certificate of origin, insurance policy or certificate, and bill of lading or combined transport document.

Documentary credits offer both parties to a transaction a degree of security, combined with a possibility, for a creditworthy party, of securing financial assistance more easily.

Buyer

Because the documentary credit is a conditional undertaking, payment is, of course, made on behalf of the buyer against documents which may represent the goods and give him rights in them. However, according to arrangements made between him and the bank-and, in some cases, by reason of local laws or regulations- he may have to make an advance deposit at the time of requesting the issuance of the credit, or he may be required to place the issuing bank in funds at the time documents are presented to the overseas banking correspondent of the issuing bank.

Seller

Because the documentary credit is a bank undertaking, the seller can look to the bank for repayment, instead of relying upon the ability of willingness of the buyer to pay. However, because the undertaking is conditional, the seller only has the right to demand payment if he meets all the requirements of the credit. It is, therefore, unwise for the seller to proceed with shipment until he is aware of these requirements- and is satisfied that he can meet them.

b. Exposure and Controls

Although parties concerned in documentary credits deal in documents and not in goods, a bank must satisfy itself that the underlying goods are properly valued, because the bank relies on the sale of goods for ultimate repayment. A bank may expose over-invoicing where title to the merchandise does not provide proper support for the bank advance made against sale proceeds. The bank can also protect itself by monitoring the type of goods being financed to ensure that they are part of the client's normal course of business.

Bills of Lading/Airway Bills

Bills of lading/Airway bills are title documents. In Negotiable Bills of Lading, the goods are consigned to order to shippers, the bank has full control of the goods until the Bills of Lading is released to the customer. In a Straight

Bills of Lading, the goods are consigned directly to buyer or a third party, the bank has no title to the goods.

Different types of Bills of Ladings:

1) Marine Bill of Lading is a document issued by shipping company showing that the goods are lodged on board of a named vessel.

2) Combined Transport Bill of Lading is one which provides for a combined transport by at least two different modes of transport from a place at which the goods are taken in charge to a place designated for delivery. This is a common discrepancy since the shipping industry is containerized.

3) "Through" Bills of Lading cover several modes of transport. However, it is acceptable to the bank according to Uniform Customs and Practices for Documentary Credit #400.

4) Short Form Bills of Lading indicate some or all of the conditions of carriage by reference to a source or document other than the bills of lading, it is acceptable to the Bank.

5) Dock Receipts/Mate's Receipts are issued by shipping company evidencing receipt of goods pending for shipment. Unless otherwise specified in the credit, these documents are not acceptable to the bank because the shipment date is unknown.

6) Bills of Lading/Airway Bills issued by forwarding

agents of charter party are not acceptable by the bank because the shipment date is unknown.

Banks are not responsible for the genuineness of bills of lading or airway bills. The bank must rely on the customer's integrity.

The bill of lading/airway bill may not be issued by a registered shipping company or air company. A forwarder's bill of lading/airway bill showing a master bill of lading/airway bill number, freight number, freight date and countersigned by authorized personnel of a registered shipping company/air company is acceptable. Without this, the bank must realize that the shipping company and airline have no responsibility on any claim of loss/damage. They merely charter the plane or ship to forwarding agents. If the forwarding company is too small to be recognized, one should consider the transaction as O/L.

c. Discrepancies

If there are any documentary discrepancies in the letter of credit, the L/C opening bank has to obtain authorization from the accountee for payment of the L/C. If the accountee does not accept the discrepancies, the L/C opening bank will not pay the bill and return the documents to the L/C negotiating bank. This represents an exposure to the negotiating bank for the full amount. The bank, therefore, should be very careful in L/C negotiations, especially in the case of back-to-back L/C's where the bank relies on the proceeds of export bills as the source of repayment. In order to protect the bank's interest, the bank usually obtains a letter of indemnity from the customer in negotiating export documents with discrepancies. The total guarantee amount accepted does not have a borrowing relationship with us, the bank can send a telex to the L/C opening bank quoting all the discrepancies and request cable authorization from the L/C opening for negotiation.

d. Insurance

Where a letter of credit is not on CIF terms, the opening bank must determine which party is responsible for the insurance, the L/C opener obtained to avoid an uncovered loss or damage to the goods.

e. Advising Credits

Advising a letter of credit to the beneficiary through a correspondent bank is preferred because the advising letter can authenticate our L/C and identify the proper beneficiary for us. The chance of forgery is also reduced. Also, the correspondent bank is an agent of the issuing bank, and, since it derives a commission from the process, it has an incentive for completing the transaction properly, although not necessarily a legal liability.

f. Confirmation of Credits

A confirmation is a credit decision and must be viewed as if the confirming bank was the issuing bank. The confirming bank commits to pay if the issuing bank is unable to make the payment.

g. Revolving Credits

A revolving letter of credit may be used by buyers dealing in non-seasonal goods requiring merchandise all year but with a controlled quantity in each shipping period. It can either be cumulative or non-cumulative. A revolving credit can be very dangerous if improperly drafted, because the total drawing under the same L/C may far exceed the established maximum usage at one time. Customer may claim to be not responsible for the excess drawing.

h. Transferable Credits

To be transferable, the letter of credit must clearly state that it is transferable. Without the L/C opening bank's consent, the baby letter of transfer cannot be further transferred. On a transferable letter of credit, the bank transfers another bank's credit without issuing its own instrument. ICC#400 provides protection for transference but is silent on rights and recourses on back-to-back transactions, the bank is left without recognized international authority or rules to refer to in case of dispute.

i. Back-to-Back Credits

1. On a back-to-back credit, the documentary requirements of the subsidiary credit must be identical to those of the master credit which should be lodged with the bank. If not, the customer may not get paid under the master L/C and leave the bank with exposure for the amount of the subsidiary L/C.

2. A subsidiary credit generally differs from the original credit in only five points:

a) The beneficiary's name

b) The account party's name

c) The amount and prices

d) The validity or expiration date

e) The shipping date

In the event of failure to comply with these terms, the bank's exposure will be the same as mentioned in 8.A.

3. Since the subsidiary credit is a projection of the original credit, the amount and prices may be reduced. The expiration date must be set at least fifteen days earlier to allow time for substitution of invoices and drafts prior to expiry of the backing L/C. Shipping dates will have to be adjusted to cover any additional transit times. Any negligence regarding documentary discrepancies exposes the bank to loss.

j. Revocable Credits

Although a revocable letter of credit is not a legally binding commitment between the issuing bank and the beneficiary, reimbursement of a drawing becomes binding once payment has occurred, regardless of amendments that may be in route. This fact must be made clear to customers who can think that they are not obliged to under revocable L/C.

Shipside bond/Shipping Guarantee

a. Definition

A shipside bond is an indemnity given by the bank on behalf of a customer to a shipping company to hold it without any responsibility for the delivery of merchandise without surrender of a Bill of Lading or other documents. By issuance of a shipside bond, the bank has given up the right of having physical control over the goods, in which case, other support such as cash margin or Trust Receipt is required from customers. In most cases, shipside bonds are used in trade where goods arrive at their destination prior to arrival of the title documents.

b. Exposure and Controls

1) Under a shipside bond, title documents are not in the bank's possession, the goods therefore may be delivered to a wrong party or at an incorrect value because the bank cannot verify that the client is the true consignee. A shipping company may claim against the bank for wrong release of goods or at a larger value and subject the bank to exposure.

2) The bank has to take unlimited liability on the

shipping guarantee issued under SSB. The bank therefore should be very careful in issuing shipping guarantees.

3) Where a shipside bond is not issued under a letter of credit, we should request an invoice/purchase order from the customer to determine the amount of exposure. Exposure is similar to those mentioned in Item A. The bank cannot verify and is not protected for the genuineness of the invoice and purchase order submitted until the original shipping documents are received.

Trust Receipt

a. Definition

A trust agreement in receipt from, between a bank and a borrower, which is temporarily substituted for other collateral when securing a loan. By means of this receipt, the bank releases documents, merchandise, or other property without technically releasing its title to the goods.

b. Exposures and Controls

1) In most cases, a Trust Receipt is nothing more than an evidence of indebtedness. For a Trust Receipt to be

otherwise, requires the importer to segregate the goods and proceeds of their sale from other goods that the importer may be selling. However, this would be very difficult for a bank to detect and control and, in practice, this segregation is not effected by importers. Realistically, Trust Receipt is pure O/L unless the goods are specifically identifiable and able to be located. An example would be a one-time shipment of a large piece of equipment bearing serial numbers.

2) Diversion of Funds

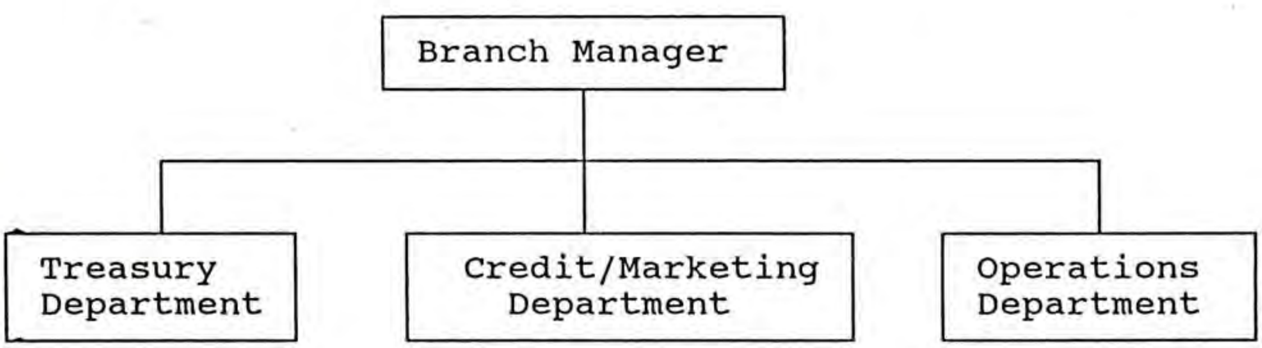
The tenor of a Trust Receipt should realistically match the customer's business cycle. If not, a longer Trust Receipt financing period than actually required can encourage customers to reinvest the sales proceeds in other ventures which leaves repayment in doubt.

CHAPTER IV

ORGANIZATIONAL STRUCTURE

Organizational structure can be defined as the arrangement and interrelationship of the component parts and positions of a company. An organization's structure specifics its division of work activities and show how different functions or activities are linked; to some extent it also shows the level of specification of work activities. For most European banks with a branch office in Hong Kong, there are normally three major departments structured in a functionalized manner as follows:

Figure 4.1
Organizational Chart of a Foreign Branch Office



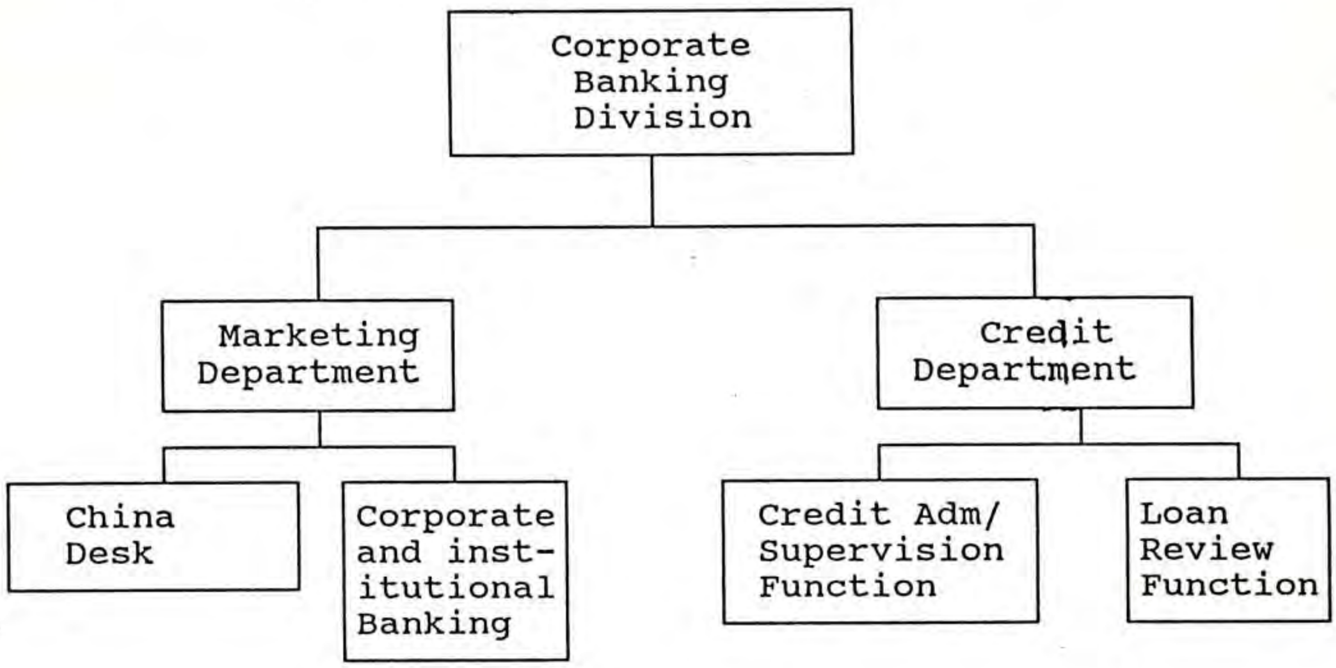
In this chapter, the traditional structures of these three major departments are overviewed and evaluated on its merits and demerits. Later on, a modified structure is proposed in an attempt to improve efficiency and effectiveness of the various functional areas in trade financing.

Credit and Marketing Department

Most Credit and Marketing organizations evolve with the growth of the lending function, in response to the need for improved systems and controls. The size and sophistication of the credit/marketing department normally bear a direct correlation to the size and complexity of the corporate banking division of the branch. The outline of the traditional credit/marketing department is illustrated below to help the reader conceptualize how some of the major credit/marketing functions might fit within an organizational structure.

Figure 4.2

Organizational Structure of Corporate Banking Division



The organizational structure of the corporate banking division is normally subdivided into the credit and marketing department.

In all the foreign banks being interviewed, the account manager system is adopted in the marketing department, which is traditionally further broken down geographically. Due to the growing importance of the China market in trade financing, a subdivision, namely China Desk, is singled out, concentrating loans portfolio from Mainland China. Locally, the account managers are organized into two teams, specializing for corporate accounts as well as institutional banking (also know as correspondent banking).

In contrast to the branch structure of the European foreign banks, many local banks with extensive branch network may organize the marketing efforts under different industrial areas, due to the bigger size and complexity of customer's portfolio. Whilst industrial specialization system of local banks may inherit the benefits of expert knowledge and experience in a particular industry, the geographical classification of foreign branch under the account manager system can train up bankers who have a broader knowledge of financial expertise. In other words, the account managers of the branch of European banks appear to be an all-rounded expertise, capable of dealing with customers from various industries and background.

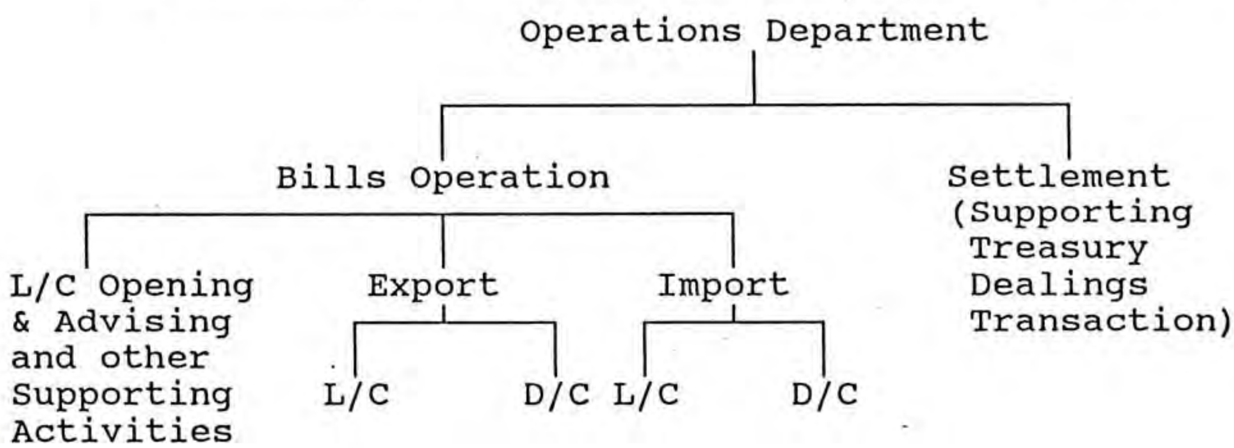
In the credit department, there are generally two major components: Credit Administration/Supervision Function and Loan Review Function. Credit Administration/Supervision Function deals with policy establishment and update, exception monitoring, overall portfolio management and maintenance of information (reporting) system. On the other hand, the Loan Review Function includes duties and responsibilities in detection of problem loans, loan approval, loan review, loan ratings, lending authorities and account officer evaluation. With regard to loan approval for amount exceeding the branch manager's limit, approval has to be sought from overseas head office. As revealed by the interviewees, the organization of the credit department can be organized in many different ways, depending on the bank's objectives, size and number of staff. Nonetheless, the structure described above is rather traditional and it can serve as a useful point of reference for other foreign branch offices.

Operations Department

In most branch office of the foreign banks, the traditional operations department can be organized as follows:

Figure 4.3

Organizational Structure of Operations Department



Traditionally, the bills operation is synonymous to the production side of a manufacturing concern in that they generate and deliver the financial services/products in trade financing to the customers. The bills department is viewed by most branch as a supporting arm of the marketing department. The functions include handling of documents related to Letter of Credit, Documentary collection and other trade financing instruments. The department is also responsible for handling international payments and processing transactions by cables and telexes with proper authentications. As trade financing represents the core business of most European banks in Hong Kong, the bills department is usually the biggest work unit of the branch in terms of number of staff.

Treasury Department

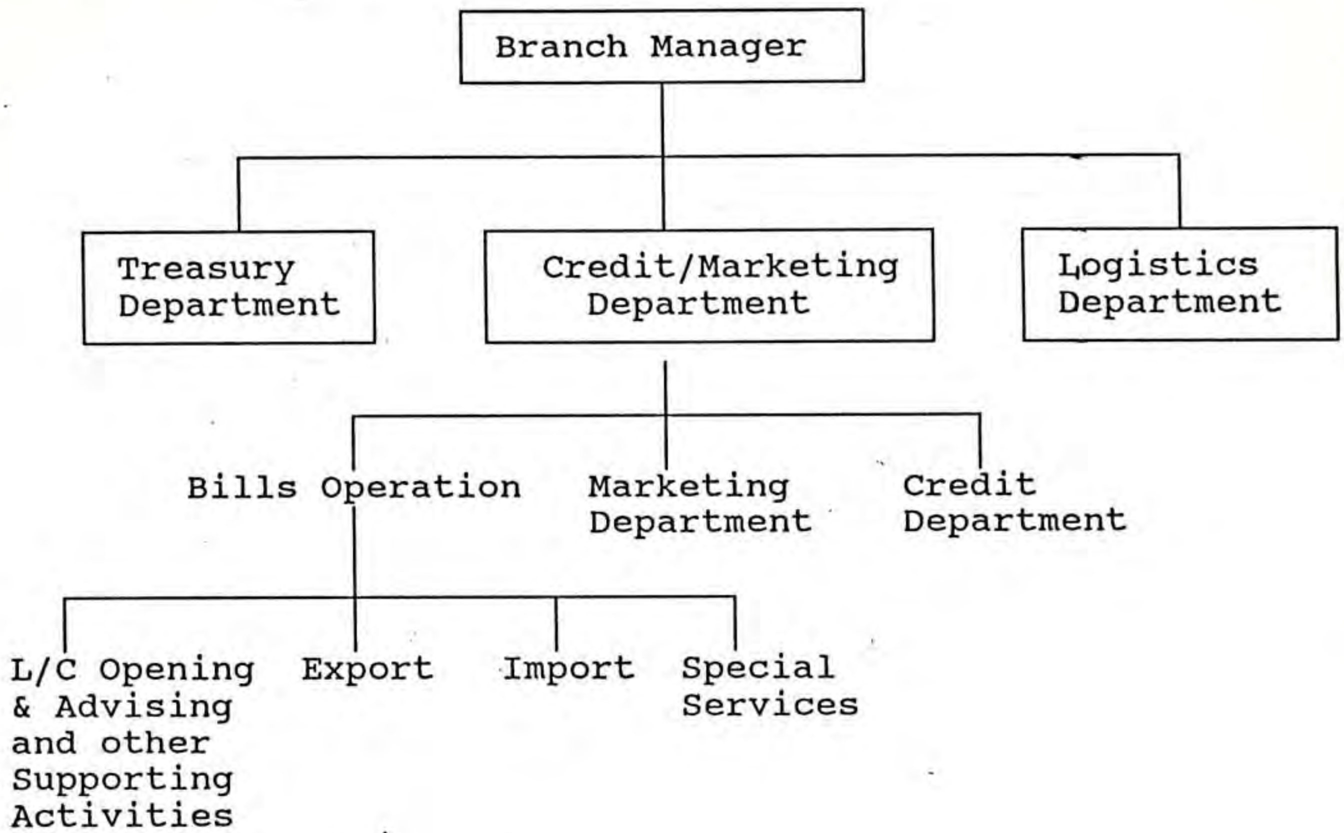
Apart from marketing and loans department, the treasury department is another major profit centre for a foreign branch. The principal activities of the treasury department are foreign exchange trading of various currencies. In trade financing, both the importers and exporters need to buy or sell foreign currencies for international trade settlement at a specific time. Therefore, many transactions of the treasury department are dealt on behalf of the exporters who may want to exchange their foreign currencies receipts for Hong Kong dollars, and the importer who may need foreign currencies to pay their overseas suppliers. In most cases, part of the bank's competitiveness in trade financing can be enhanced by a competitive bid-ask price quoted by the treasury department to the customers. As a result, the account manager in the branch has to work closely with the treasury department to negotiate any reasonable but attractive foreign exchange rates for the customers in order to secure more business.

Modified Organizational Structure

To enable the corporate banking activities to run smoothly and efficiently, a modified organizational structure is proposed in this section. All the modifications are made in an attempt to enhance greater cooperation among departments and provide better quality services. The structure is illustrated in figure 4.4:

Figure 4.4

Modified Organizational Structure



HIGHLIGHTS OF THE MODIFICATIONS OF THE PROPOSED STRUCTURE

1. One particular modification in the structure is the placement of the bills operation department under Corporate Banking. In contrast to the traditional structure where bills operation is envisaged as a cost centre and supporting department of marketing, the bills operation department is considered as an individual profit centre and evaluation will be made based upon (1) Business volume of bills business, (2) head counts, that is, the rate of processing transactions by

the bills staff, and (3) cost/income ratio which is an useful tool to measure the efficiency as well as effectiveness of the department. The rationale for the structure is that customers in trade financing emphasize not only the services by account manager, but also the efficiency of the bills operations. Therefore, if the bills department is placed under corporate banking and viewed as a profit centre, the staff in the department are supposed to work with higher incentive and hand in hand with the marketing manager so as to maximize their performance.

2. In general, there are numerous technical and operational problems in most bills transactions that the account manager may not be able to answer the customer immediately. Accordingly, in order to provide excellent and efficient services to customers, the bills head or manager can make joint call with the account manager. Because of the assumed increasing cooperation between the bills and marketing department, the bills department should be no longer treated as a supporting centre. By structuring the bills department, marketing and credit department under corporate banking division, the corporate banking activities can be run smoothly and efficiently, thereby enhancing the bank's competitiveness in trade financing.

3. It is generally true in trading financing that the 80-20

rule still applies, that is, eighty percent of the businesses actually come from twenty percent of the customers. Thus, special and superior services provided to these big customers should never be overlooked. In this connection, it is proposed that a Special Services Unit should be established under the Bills Operation Department. The unit is assigned to process transactions only for the bank's largest customers who in most of the time demand excellent services from their bankers. In order to solicit more bills business from these customers, the Special Services Unit is playing an important role not just in providing efficient services but also in giving them a sense of superiority in the bank.

4. Apart from the Treasury and Corporate Banking Division, the Logistics Division is set up to provide support activities in different areas such as dealing room settlement, EDP, Administration as well as accounting services.

The proposed modified structure is attempted to illustrate how functions in a branch might be logically segregated in a more efficient and effective manner. It should be noted that these functions can be mixed or combined with the traditional structure in other ways, depending on the bank's objectives, size, staff, and so on.

CHAPTER V

CREDIT POLICY AND PROCEDURES

In order to safeguard the bank's interest, lending activities have to be guided by pre-set credit policies and procedures. Every foreign bank under research has a general loan policy outlining the conditions and authority required to extend credit. Whilst most foreign banks prefer to have a more flexible credit policy to retain their competitiveness, it is worthwhile to review and summarize their general credit policy and risk assessment in this chapter.

Principles of Lending and Risk Assessment

Targeting at customers from large corporations, most foreign banks consider flexibility in lending considerations as one of the key factors to sharpen their competitiveness.

Nonetheless, the account manager has to consider interrelationship of different elements in the principles of lending in order to form an overall view. It is, therefore, the objective of this section to revise some of the important lending considerations that the account manager has to take into account.

Purpose and Nature of Proposition

The account manager must first understand the purpose of advance, whether it is to increase borrower's current assets, to increase borrower's fixed assets, or to discharge borrower's existing current liability. Short term advances are preferred for transactions of a self-financing nature with repayment funds generated from disposal of specific trading assets. Trade financing is one of the commonest example of self-liquidating loan. On the other hand, it is a general policy of the banks interviewed to avoid financing ventures in property financing which sound too risky for the bank to take position in the long term.

Adequacy

As a general guideline, the requested advance amount has to be adequate to serve stated purpose of advance. Underestimation may lead to topping-up lending later. Besides, the banks also avoid excess advance amount putting bank at high risk. Therefore, assessment of cost requirement and anticipated cash flows is conducted by account manager.

Repayment

The question in lending, in most cases, is reliant on earnings and successful sales as source for repayment. In this regard, projected budget figures are requested to show the application to be made of the bank advance and outlining expected receipts/expenditure and net profit before depreciation over the term of the advance. This helps identifying the maximum borrowing requirement and structuring realistic and "livable' repayment schedule whilst avoiding over-optimism on the borrower's part.

For projects, the account manager will watch out for mismatching of foreign exchange which may lead to difficulty for repayment. In this regard, the account manager has to meet regularly with manager in the treasury department to keep updated information of the foreign exchange market.

Reliability and Abilities

These are highly related to the character and capabilities of the customers. Assessment is based upon borrower's ability to apply advance to the stated purpose of advance. Management and expertise as evidenced by past performance is also important.

Stability

One of the considerations in stability is the length of establishment of borrower company. Effects of business cycle on related industrial sector are checked whether these led to 'see-saw' results of borrower. Review of performance is conducted for at least one business cycle.

Financial Conditions

The current state of financial health of the customers are assessed on a 'going-concern' basis. Attention is focused particularly on the relationship between firm's sources and proportion of financing, its resources and its earning ability. Account manager has to watch for overtrading (to be discussed in more details in later section) where scale of business operations outstrips available financial resources. Moreover, the manager need to consider the impact of proposed borrowing on financial position.

Bank's Share of Financing

There are generally three guidelines:

a. Proprietor's stake should be more than that of total bank advance, that is, shareholders' funds ought to exceed total bank advance.

b. For healthy companies, a bank might go as far as providing half of a firm's working capital requirements by way or unsecured lending.

c. For healthy companies, as much as half the value of current assets might be lent with appropriately secured lending.

Security

In most of the loan portfolio of the foreign banks, they are granted on clean basis. As explained by the interviewee, security should be the final consideration in an application for facilities. In practice, if the banker is not already sure the facility will be repaid by the customers, the question of security is no longer needed to be considered. This is because the account managers believe that no amount of security can change a bad proposition into a good one. If there is a possibility that the security will have to be realized to repay the borrowing, it is usually better not to lend. The foreign banks interviewed reveal that it is very bad for the image of a bank if it often has to evict customers from the security, especially charged property.

Control

Regular submission of borrower's financial statements is required to monitor position of advance. Credit facilities are usually granted under the condition of "subject to annual review". In this connection, under the proposed organizational structure where bill operations department is organized hand in hand with the marketing and credit department, the account manager can quickly detect any irregularity of business transactions in trade financing, which means a better control over the portfolio of the corporate accounts.

Others

The European banks always offer competitive but reasonable pricing. This should be structured to reflect customer credit or project risks. Specially, the account will never extend loans purely because loan pricing is attractive. What is more appealing for foreign branch, as most interviewees reveal, is the excellence of service that the account manager provides.

Guidelines in Credit Reporting

As in all other banks, the European banks under study emphasize much on the reporting function which records officially the bank's commitments and loan arrangements with its customers. All credit extensions of the bank, its subsidiaries and managed affiliates, to any one borrows on a global basis must be assembled and reported to the appropriate review body. The recording vehicle for this function is a 'Credit Approval Report', and the review body is the branch manager. The principal objective of the review function is to ensure that the bank's current credit policy is being observed, especially as it relates to quality and adequate return.

In order for the review function to be effective, it is essential that all new increased, restored or modified credit extensions be reported on a timely basis. If the purpose of the report is not an annual review, only those credit extensions requiring approval and review must be reported in detail, those not requiring approval or review may be summarized.

In this section, the guidelines in credit reporting followed by most of the European banks are summarized in form of a checklist as follows:

a. Name of client and its location

b. Details of Facilities

This includes the description of the nature of credit facilities:

- total credit limit and sublimits
- whether clean, secured or partly secured
- whether advised or internal
- new or renewal, increased or decrease
- interest rates charged to the customers
- tenors of each facility line
- handling commission (if any)
- drawdown schedule/repayment terms
- other conditions (if any)

c. Support

Collateral in sufficient detail is described to adequately substantiate the values involved, for example, deposits and personal guarantee which are the commonest collateral taken by the European branch office.

d. Purpose of Loan

The purpose of loan must be stated as whether the loan is for working capital financing or production capacity expansion and so on.

e. History and Background

- Date of incorporation
- nature of business
  - primary or principal product lines
  - secondary or supplementary product lines
- affiliates
  - list of affiliated companies and operating relationship with them (this is especially important for foreign banks to consider the background of the prospects who are multinational corporations and are referred by the bank's overseas head or branch office.)
  - list of subsidiaries: extent of ownership
  - name of parent company
  - their business history
- Capital investment and key stockholders
  - extent of paid-up capital, net worth
  - names and investment of large stockholders
  - other current information of development

f. Organization and Management

- organization structure
- list of corporate officers and qualifications, experience
- list of members of the board of directors
- background of the management personnel

- reputation in trade and business circles

g. Operation

- nature of operations of the firm
- products/services, production capacity, sources of materials/supplies, price and terms of sales, channels of distribution, expansion/diversification plan

h. Bank Checkings

This included the date when investigation was conducted, list of bankers, facilities enjoyed, amount facilities and outstandings, pledges or mortgages attached to the granting of these facilities, bankers' experience

i. Financial Statement Analysis

Financial statement analysis is an important tool for credit analyst to assess the financial standing of the customer. This area will be discussed in more detail in the next section.

J. Evaluation of Cash Flow Projection

- Review assumption used by the client in preparing the projections
    - is the sales volume projection consistent with present production capacity and planned expansion?
    - are the prices and terms of sales justified in the light of present market conditions?
    - are production costs in line with past

experience and inflationary pressures?

- is the amount being requested supported by the cash flow forecast?
- what about other sources of financing

- Make adjustments in the cash flow if such are warranted by assumptions that are unrealistic
- State your conclusion
  - how much does the company need?
  - when
  - when can we expect repayment

k. Other business relationship
- when relationship was first established
- analysis of accounts
- present outstanding
- overall experience with subject firm

l. Securities Analysis (if any)

Most of the European banks aim at corporate customers who have long history of business and sound financial standing. As a result, a large portion of the facilities granted to customers are on clean basis, that is, not any tangible assets are charged against the loan. In contrast to most local banks which take property, debenture and shares as securities, the commonest security that the European banks take is cash deposit, normally supported by personal or corporate guarantee. Hence, in case of clean loans granted with the support of personal guarantee, the focus of analysis will be on the personal networth assessment.

m. Industry and Market Analysis

The European banks under research stress much on the industry and market analysis. As a general guideline, general market information including principal competitors within the industry and effects of competition on the company's performance is analyzed. Account manager has to study the cyclicality, elasticity of market and market trend too in order to judge whether the customer is capable of running the business properly.

n. Credit Risk Analysis

In this analysis, account manager has to address to the question "Why this is a good credit or if this is a problem, what are the difficulties to be encountered?" To answer this question, the manager has to outline significant strengths and weaknesses of borrower or guarantor. By learning the reputation, capability, depth, and continuity of management of the proposed customer, the manager has to identify the risk elements in the credit and highlight any protective features that mitigate the risk elements in sales, production, supply and collection. To be more specific, the account manager need to quantify the exposure of the bank to subject company.

o. Recommendation

In the recommendation, the account manager should set up criteria in establishing credit ratings in the following areas: short-term solvency, long-term stability, profitability, historical and outlook, banking experience and paying habits, management and operation, position in the industry and prospects of the said industry, and lastly the ability of the company to repay the loan based on the cash flow projections throughout or by the end of the period.

Financial Statement Analysis

Importance of financial analysis in credit analysis

A balance sheet is a statement of the liabilities and assets of a business at a single moment in time which is usually the end of the accounting period to which the financial statement relates. An obvious disadvantage of balance sheets is that they record a position which existed on a certain date in the past. This may not match with what the banker desires as he chiefly wishes to know the position which is likely arise in the coming months or years from the financial statement. Therefore, as revealed by the interviewees, they consider financial analysis as not only methods of gathering factual information from a balance sheet, but also its value as a guide in the assessment of the future outlook for the business to which it relates.

Targeting its customers at corporate level, the audited financial statement submitted can be a useful aid to the assessment of the lending proposal. It gives the account manager and credit analyst a clear idea of the business to which its relates. Accordingly, before reading the financial statements, the banker must know the nature of the business and the purpose of the proposed advance which are usually the most important consideration for the foreign banks to grant loans on clean basis.

As all the interviewees disclosed, the spreadsheet is the basic technique employed by the account manager and credit analyst in extracting the figures of a balance sheet in a systematic way which not only helps simplify the general picture, but also prevent the overlooking of important items. Undoubtedly, there are variations in detail between the methods of extraction practised in different banks, but the principles must be common to all. It is, therefore, the objective of this section to proposes a complete set of guidelines in financial analysis for the readers as reference.

Some of these guidelines are particularly stressed by the interviewees from their standpoint of a foreign banker.

Guidelines for Financial Analysis

a. Short-term liquidity

- reasons behind the increase/decrease of current assets
- reasons behind the increased/decrease of current liabilities
- significance and breakdown of current assets into major components
- sources of working capital and significance
- reasons of the increase/decrease of receivable turnover
- credit terms extended to customers
- credit terms extended by suppliers
- reasons for increase/decrease in inventory turnover
- percentage of credit sales to total sales
- breakdown of finished products inventory in major products
- quality of receivables
- nature of inventory and breakdown

b. Capital position and Long-term liquidity

- Composition of long-term debt; purpose, maturity schedule, annual amortization- effect on both the company's long-term and short-term positions.
- Composition of stockholders' equity; amount and type of capital stock, number of shares issued and outstanding, par value and book value/share, stock dividends issued, retained earnings and other surplus accounts, each dividends issued.
- Significance of the increase/decrease of stockholders' equity
  - additional issuance of capital stock; stock dividends issued
  - sources of retained earnings inflows; reasons behind the account's movement

c. Profitability and Operating Performance

- reasons for the increase/decrease in sales or revenue
- reasons for the increase/decrease in cost and expenses
- effect of fixed charges (overhead) on the company's profitability structure
- reasons behind distinct movements or fluctuations in returns
- components of cost changes and extent of such changes

d. Total Resources and Revenue

- Breakdown of revenue sources
- reasons for increase/decrease in revenue level - significance
- breakdown of sales in export and domestic
- breakdown of resources into major components and justifications
- reasons for increase/decrease in resources level- significance

e. Historical Cash Flow Evaluation

- Breakdown of operational and non-operational inflows
- Breakdown of operational and non-operational outflows
- significance of sources of non-operational cash
- significance of applications of non-operational cash
- reasons behind distinct cash movements from year to year

Assessment of Credit Limits

In assessing the credit limits, the bank will usually consider the trend of annual sales and seasonal patterns of subject company in connection with the terms of sales and procurement sources and terms. One of the major assessment is the track of overtrading. Overtrading means the owner's desire to expand too fast without necessary own financial base. The available working capital comes under great strain when the turnover is attempted to be increased more rapidly than normally possible. Increased debtors, larger overheads, increased stocking and work-in-progress all lock working capital. Consequently, as turnover expands, more liquidity is required to help finance these item, and unless this is rectified by the introduction of further capital, the strain will continue to be experienced until the resulting increase in profit is realized and retained in the business.

a. How to detect overtrading from the bank account

- The development of a 'hard core' or constantly drawn balance in the account. A healthy borrowing account is one which show periodical fluctuation indicating continuing business activity and payment by debtors. If the account is overdrawn to a major extent at all times, it means slow-down in collections or diversion of sale proceeds to build up further inventories at the cost of delaying regular business payments.

Sometimes, any purchase of fixed asset or loans made to other group companies, may result in the hard core in the bank account. Naturally, they are not indicative of overtrading, but improper financial management.

- 'Hard-Pressed' account dealings by the borrower. Where the customer continually draws cheques before paying in the covering funds in the account, or regularly issues post-dated cheques, it is indicative of customer's financial straits.
- Payment of creditors irregularly or in round sums 'on account', or in advance to obtain deliveries which would not otherwise be forthcoming.
- The need for weekly excesses in the account for wage payments.

According to the managers of the interviewed banks, there are also some potential problems that have to be watched out.

- Go regularly to see the customers' operations, don't just process paper, take a look at the goods you are financing, and ensure that the bank's title under the trust receipt can be enforced.

- Thoroughly and regularly check the ownership and credit standing of all overseas companies on which D/A and D/P bills are drawn and beware of discounting D/A bills if the overseas customers are in any way related to the company you are providing trade financial for in Hong Kong.
- Do not roll over any trade finance facility without a thorough investigation into the reasons for the customer's failure to meet its commitment. Such a request can be the first sign of trouble.
- What is the company's business cycle? If it is 30 days, why grant 60, 90 or 120 day trust receipts?
- How good is your security? Could you dispose of the goods, assuming that is, you could gain possession in the first place?
- If more than one bank is involved, where do you stand in the complex network of trade finance?

  As warned by the interviewee, one bad debt could write off the entire profits you have made from trade finance facilities over the previous three years.

b. Overtrading seen from the financial statements

Features that can be read from financial statements about overtrading can be summarized as follows:

- Current liabilities substantially in excess of capital resources.

- Small capital resources in relation to turnover.
- A declining debtors/creditors ratio.
- The taking of longer credit on purchases and/or giving shorter credit on sales than the usual practices in the trade, than previously done by the client.
- The appearance of bills payable.
- Increased overheads coupled with diminishing cash resources.
- Increased borrowing from all available outside sources at high interest rates.

The above indicators may not conclusively show that a client is overtrading to an excessive extent. In any growing business, a slight degree of overtrading can exist without danger. Nevertheless, a close watch of the situation is required.

CHAPTER VI

MARKETING / LENDING OF TRADE FINANCING

In most European banks, the account manager system is adopted in order to assure that the effort is responsive to the customer's needs and expectations. In addition to handling credit transactions, the account officer is also responsible for account management, that is, report and follow up on the customer accounts, to continuously identify pending needs of the customers, which would ultimately result in new business for the bank. Follow up work includes analyzing the customers' financial trends, ensuring their compliance with terms and conditions of the credit agreement, servicing their day-to-day needs, and visiting them to learn more about the operations. In the course of business development, the account officer has to solicit new accounts, market new banking products and services, phrase out unprofitable and delinquent accounts so that the bank will be in a healthy and profitable trend, with sustainable growth. To understand fully the marketing and lending activities in trade financing, we will look into several perspectives of marketing in this chapter: objectives that the manager has to achieve, preparation, implementation as well as follow-up activities.

Objectives

The first objective that the account manager has to achieve is to identify existing and potential areas of opportunity and vulnerability. In the case of the European banks under study, they chiefly target at customers from middle to up market level who appear to be strong enough to support a clean line of facilities. In trade financing, these customers are mostly large trading houses or multinational corporations with manufacturing basis, either in Mainland China or in South East Asian countries like Vietnam and Thailand. In particular, the interviewees revealed that another source of customers are referred by their head offices which usually have an extensive branch network in their home country. Therefore, it is natural that the branch office in Hong Kong will also aim at local customers who have business relationship with buyers or suppliers in the home country, say, Germany or France.

Once the account managers have identified the business opportunity, they have to communicate the bank's desire to strengthen and expand relationship both in terms of service and account profitability. Indeed, as the most European banks in Hong Kong merely have one branch office in Hong Kong, the bank has to provide tailor-made services, maintain close relationship with clients and be responsive and flexible enough to accommodate to the client's needs in order to compete with the local giants with extensive branch network.

Because of the highly competitive environment in trade financing, the account manager has to be able to identify key players at customer and their counterparts and the competitive bankers. It is important for the manager to utilize as basis for ongoing dialogue of customer's needs and expectations, as well as the bank's capabilities and performance.

To ensure the quality of lending proposal on new customers, it is proposed that the bank should not attempt to impose any quota system on the account manager. The rationale behind is that good lending should be based on good customer with high integrity, clarity of loan purposes and strong repayment ability. This simply may not be feasible if the lending is made by hard selling. As remarked by one of the interviewee, one bad loan can erase all the profits you made in the past several years.

Preparation

In preparation, the account manager need to establish genuine interest by customer, i.e., commitment. The scope of review must be defined mutually in the following aspects:

- global: parent and subsidiaries
- specific products - services
- credit
- data required, i.e., input from field/other organizational units
- Identify critical issues to be addressed: pricing; quality/timeliness
- Formulate tentative agenda
  - type of review
  - select participants
  - secure top management endorsement

Implementation

In the implementation stage, the account manager has to determine the dimension governing the existing relationship including details regarding the customer, the bank, quantitative data including amount and terms of loans and key individuals. By evaluating past failure, the manager need to identify key obstacles to developing relationship and make any suggestions for improving relationship. In trade financing, as customers demand also high quality services in bills operation, it is therefore a good strategy for the account manager to jointly call the customers with the bills head or manager. Based on preliminary discussions and input from all the parties, target opportunities for improving relationship can be selected from the bank's viewpoint.

Follow-up

As suggested by most managers interviewed, they stress a lot on follow-up activities. This includes evaluation of performance of the bills and current account of the customers after review of facilities. This area would become stronger with a closer relationship between the bills and marketing department which, as explained in the section of organizational structure, are both under corporate division. By means of regular follow-up, the account manager can identify areas of improved cooperation and prepare action plans including targeted goals, time frames and responsibility.

CHAPTER VII

SUMMARY AND CONCLUSION

Hong Kong as an international financial centre and important entrepot for China has given banks numerous opportunities for business development and profits making. The banking industry depends very much on the performance of the economy as a whole. As a major port servicing the Asian-Pacific region and China, the outlook of the economy of Hongkong appears to be rosy.

In comparison to the depressing economy of the States and Japan, the emerging unified Europe is now seeking way out to develop their markets in the Asian-Pacific region and Hong kong can well serve as a fitted place for European banks to establish their foothold. As revealed by most European bankers interviewed, trade finance plays a big role in their operation. But it is also because of the growing importance of trade finance that a lot of banks are competing to share a small portion of the cake. For European banks which just maintain a branch office in Hongkong, they must improve their quality of services to customers by the different functional areas in the banks.

A well-structured organization chart becomes the first prerequisite for offering tailer-made services to customers. The proposed structure is designed to meet the specific needs of the sophisticated trade financing customers. The innovative idea of consolidating the functions of credit, marketing and bills operation department under corporate banking division is based upon the assumed close relationship among the three departments. Nonetheless, the adoption of the structure is highly dependent on the size and objectives of the banks, hence modification is needed.

On the credit and marketing side, it is common practice by most banks to keep their credit manual and policy as flexible as possible. Therefore, only general guidelines are provided for account manager in managing the accounts. In this regard, the paper proposes a set of information for both credit and marketing which are expected to serve as a frame of reference for practising bankers.

With the optimistic economic outlook of China and the Asian-Pacific region, bankers are ready to capture excellent business opportunities in trade finance. Whilst the focus of the banks is also to leverage their relations with the customers back home in Europe, banks that can establish a sound organization structure couple with the excellent management in credit and marketing are more likely to be a long run winner in the industry.

APPENDIX I

INTERVIEW GUIDE

A. Background Information

1. The home country of your bank is __________ ?

2. Years of history of the banking business in Hong Kong __________

3. The number of employees currently hired in Hong Kong __________

4. What is the mission statement of the local establishment of your bank in Hong Kong?

5. Please state the relative emphasis of your bank in :

   individual banking ____________

   Institutional banking ____________

   Merchant banking ____________

8. Are there any motives and reasons behind your emphasis of the above banking activities? How do you comment on the prospect of this banking activities in Hong Kong?

9. What is the overall organizational chart of the local establishment of your bank?

10. What is the organizational structure of the bills department? Which departments interact with the bills department most of the time?

11. How are the policies in the Bills Department being formulated? By whom are they formulated? Do you regard the decision making process as centralized or decentralized?

B. Bills Operation

1. Can you introduce the major trade financing instruments offered by your bank?

2. How is the efficiency and effectiveness of the bills department being evaluated?

3. How can your bank enable the smooth operation of the bills department with the credit/marketing department?

C. Bank Lending

1. What is the normal process of the credit analysis in your branch? What are the risk elements involved and how does your bank protect from risk when granting facilities to the clients?

2. How important is the financial analysis in the credit analysis process?

3. How are the different classes of risks changing in the past decade?

4. What are the types of securities required? Margin?

5. What are the bank's polices in handling problem loans?

D. Marketing

1. How does your bank segment your customers?

2. What are the sources of customers of your bank in Hong Kong?

3. Does your bank make use of any marketing model or selling process in trade financing business?

4. What are the competitive strategies of your bank?

5. What are the key elements to survive and grow in the market?

6. How do you comment on the prospects of trade financing business in Hong Kong? What are the threats and opportunities of trade financing business in Hong Kong in context with the huge market of Mainland China?

7. The one business that most foreign banks in Hong Kong do not touch is general retail banking. How do your bank react then to compete with the local competition such as Hong Kong, Heng Sang Bank in trade financing business in view of the lack of retail network? How do you compare the customer profile between your bank and other competitors in Hong Kong?

APPENDIX II

LIST OF INTERVIEWEES

1. Banque Worms (Hong Kong Branch)

Address	:	15/F., Luk Kwok Centre, 72 Gloucester Road, Hong Kong.
Telephone	:	5285470
Interviewees	:	Mr. Thomas P. K. Tao (Senior Manager - Operations) Mr. Maxwell Yeung (Senior Manager - HK & China Division)

2. Bayerische Vereinsbank AG

Address	:	41/F., Bank of China Tower, 1 GArden Road, H.K.
Telephone	:	8201303
Interviewee	:	Mr. Michael Grabowski (Executive Vice President & General Manager)

3. Union Bank of Switzerland

Address	:	13/F., Glouster Tower, The Landmark, Hong Kong.
Telephone	:	8461111
Interviewee	:	Mr. Johnny Y. S. Cheng (Strategic Planning & Control Manager)

4. Westdeutsche landesbank

Address	:	Far East Region, B.A. Tower, 36th Floor, 12, Harcourt Road, Hong Kong.
Telephone	:	8420272
Interviewee	:	Mr. Richard McDonald (Senior Vice President and General Manager)

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Bayerische Vereinsbank AG, Mr. Michael Grabowski (Executive Vice President & General Manager), 23 March 1992.

Union Bank of Switzerland, Mr. Johnny Y. S. Cheng (Strategic Planning & Control Manager), 6 April 1992.

Westdeutsche landesbank, Mr. Richard McDonald (Senior Vice President and General Manager), 13 April 1992.